

General Information Letter: Application of the "paid in this State" rule for determining when compensation is subject to withholding.

November 22, 2005

Dear:

This is in response to your letter dated September 23, 2005, which was received by this office on November 7, 2005, in which you request advice. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information, the regulation governing the issuance of letter rulings, 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department, can be accessed at the Department's website. That address is www.revenue.state.il.us/legalinformation/regs/part1200.

The nature of your question and the information provided require that we respond only with a GIL.

In your letter you state as follows:

I am with the COMPANY, and we publish books and teach classes about employers' payroll tax responsibilities. Tens of thousands of employers get their guidance from us, so it is important that we have the correct information. The information I am requesting below is needed for the benefit of our subscribers to our publication, *APA's Guide to State Payroll Laws*, and our biweekly newsletter, *PayState Update*.

Can you please tell me how employers operating in your state should withhold income tax from employees who are residents of your state but perform services in another state?

1. Should the employer withhold your state's income tax from the wages of a resident employee working in another state?
2. Does it matter whether there is a withholding tax in the other state in which the employee works? It seems that most states answer this question in one of four ways. Does one of the below match your state's approach?
 - a. Withhold your state's tax, no matter what is required by the other state in which the employee works.
 - b. Do not withhold your state's tax, no matter what is required by the other state in which the employee works.
 - c. Withhold your state's tax unless tax is withheld for the other state in which the employee works.

d. Withhold your state's tax, allowing a credit for any tax withheld for the other state in which the employee works.

3. Should the employer report the wages earned in the other state on this employee's Form W-2, *Wage and Tax Statement*, as wages for your state (in addition to reporting them as wages for the other state in which the employee works)? Again, most states seem to use one of the following approaches:

a. Report all wages;

b. Do not report; or

c. Report if the employer does not withhold for the other state in which the employee works?

4. Should an employer operating in your state withhold from the wages of a *nonresident* who performs services for the employer in your state (assuming the absence of any reciprocity agreement)?

a. Are there any thresholds (wages earned in the state or days worked in the state) to be exceeded before withholding is required?

b. If there is a threshold, once the employee meets it, is withholding required from all wages earned in the state, or only from wages past the threshold?

c. If there is a threshold, and the employee has not met it, does that preclude the requirement to report the wages in your state?

RESPONSE:

For all of these responses, we assume that the employer in question is required under the Internal Revenue Code to implement wage withholding from the employee.

Question 1:

In response to Question 1, please be advised that the law governing withholding of wage income is found at Illinois Income Tax Act (IITA) Section 701, 35 ILCS 5/701. That law states in pertinent part as follows:

(a) In General. Every employer maintaining an office or transacting business within this State and required under the provisions of the Internal Revenue Code to withhold a tax on:

(1) ***Compensation paid in this State (as determined under Section 304(a)(2)(B) to an individual;*** or

(2) payments described in subsection (b) shall deduct and withhold from such compensation for such payroll period (as defined in Section 3401 of the Internal

Revenue Code) an amount equal to the amount by which such individual's compensation exceeds the proportionate part of this withholding exemption (computed as provided in Section 702) attributable to the payroll period for which such compensation is payable multiplied by a percentage equal to the percentage tax rate for individuals provided in subsection (b) of Section 201.

(b) Payments to Residents.

Any payment (including compensation) to a resident by a payor maintaining an office or transacting business within this State (including any agency, officer, or employee of this State or of any political subdivision of this State) and on which withholding of tax is required under the provisions of the Internal Revenue Code shall be deemed to be compensation paid in this State by an employer to an employee for the purposes of Article 7 and Section 601(b)(1) to the extent such payment is included in the recipient's base income and not subject to withholding by another state... (emphasis added).

In determining whether compensation is paid in this state, IITA Section 304(a)(2)(B) provides as follows:

(B) Compensation is paid in this State if:

(i) The individual's service is performed entirely within this State;

(ii) The individual's service is performed both within and without this State, but the service performed without this State is incidental to the individual's service performed within this State; or

(iii) Some of the service is performed within this State and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within this State, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State... (emphasis added).

Using the law as set forth above as a guide, if the compensation paid to the Illinois resident is considered to be "paid in this State" under IITA 304(a)(2)(B), then it is clearly subject to withholding of Illinois income tax. If it is not "paid in this State," it may still be subject to Illinois income tax withholding under IITA 702(b).

Question 2:

See answer to **Question 1** above. Additionally, Illinois allows a credit to individual residents for taxes paid (not withheld) to a foreign state under IITA Section 601(b)(3), provided no reciprocal agreement is in effect with the other state.

Question 3:

In response to this question, all wages would be reported on Form W-2, since they are all subject to Illinois income tax withholding under IITA 701(b).

Question 4:

In answer to this question, there is no specific dollar threshold of compensation income which triggers withholding under the circumstance described. If the nonresident employee's services are performed entirely in Illinois, the compensation is subject to withholding. If the services are performed inside and outside of Illinois, but the services performed outside Illinois are "incidental" to those performed in Illinois, all of the compensation is subject to Illinois withholding. If the services performed outside of Illinois are not "incidental" to those performed in Illinois, then the compensation income will only be subject to Illinois withholding if the employer has its base of operations in Illinois or the employee's services are controlled or directed from the employer's Illinois location.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200.

Sincerely yours,

Jackson E. Donley,
Senior Counsel-Income Tax